Illinois Commerce Commission
Electric Policy Committee Meeting
FERC Standard Market Design NOPR[1]
October 15, 2002

Comments of Centrica North America / Energy America

1 Summary

Centrica North America ("Centrica") appreciates this opportunity to share its views with the Illinois Commerce Commission ("Commission") on the Federal Energy Regulatory Commission's ("FERC") Notice of Proposed Rulemaking ("NOPR") on Standard Market Design ("SMD"). As one of the largest electricity retailers, Centrica supports the development of open, competitive retail markets to complement the restructuring of wholesale electricity markets.

SMD would provide some much-needed consistency in wholesale market rules, would broaden the reach of wholesale competition, and incorporates some hard-learned lessons from the first five years of electric industry restructuring in this country. While the focus is clearly on improving wholesale markets, the proposed changes affect all parties who rely on them, including marketers and, especially, consumers.

Having participated first-hand in the successful development of retail competition in the United Kingdom, Centrica believes that development of retail markets is critical if consumers are to reap the full benefits of electric industry restructuring. Retail markets are still in their infancy in the United States, however. Care must be taken that retail market development is not unintentionally harmed in the process of making improvements to wholesale markets.

In these comments, we point out two specific features of SMD that threaten to impair the development of competitive retail markets. The harm lies not with their intent, but with the details of their proposed implementation.

1.1 About Centrica North America

Centrica North America encompasses the North American operations of Centrica plc ("Centrica"). Centrica is the leading supplier of energy and essential home and road services for British consumers, employing approximately 30,000 people. Centrica's businesses include energy supply and home services under the British Gas and Scottish Gas brands; automobile services under the AA brand; insurance and financial services under the AA and Goldfish brands; and telecom services under the British Gas and One.Tel brands. Worldwide, Centrica

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1 These comments are in conjunction with the Illinois Commerce Commission's October 15, 2002 Electric Policy Meeting regarding FERC Docket No. RM01-12-000, as announced in its September 26, 2002 notice.

has approximately 44 million customer relationships. For the financial year ended December 31, 2001, Centrica reported sales of approximately £12.6 billion (US $17.6 billion).

Centrica entered the North American retail energy market in 2000. Since that time, through both organic growth and acquisitions, Centrica North America has grown to an enterprise with approximately 3.7 million customer relationships. In the United States, Centrica North America, through its subsidiaries, has become one of the largest multi-state providers of deregulated energy services, with more than 600,000 customers located principally in Georgia, Michigan, Ohio, Pennsylvania, and Texas. In April 2002, Centrica North America announced a deal with American Electric Power to acquire over 800,000 residential and small commercial electricity customers in Texas.

Through its Energy America subsidiary, Centrica is authorized by FERC to participate in wholesale electricity markets throughout the country. Energy America is in the process of submitting an application with the Commission for certification as an alternative retail gas supplier in Illinois. Through Energy America, Centrica is evaluating potential opportunities in retail electricity markets, including Illinois. As a potential participant in the Illinois retail electric market for residential and small commercial customers, Energy America has a substantial interest in the SMD as well as the Commission's views on the impact of the SMD on the development of appropriate retail market structures in Illinois. Any impacts of the SMD on the Illinois retail electric market should be consistent with the Public Utilities Act (the "Act") and ensure that all Illinois consumers are treated fairly, continue to receive reliable electric service, and are allowed to purchase electric power and energy from the provider of their choice in accordance with the Act.

2 Importance of retail markets

Retail competition ensures that savings in wholesale costs are passed on to consumers rather than retained by their retail providers. Competition among marketers also creates the necessary incentives to continually pursue improvements in retailing costs and customer service. This vision of retail competition requires, among other things, active participation by multiple retail firms, and the ability of new firms to quickly enter the market in response to varying market conditions. Any impediment to the entry of such firms into the market will undermine the basic goal of competition upon which customer benefits ultimately reside.

Retail market development is also beneficial to the performance of wholesale markets. An efficient wholesale market requires participation not only by producers, but also by consumers. Demand participation in wholesale markets has generally been lacking, though the benefits of increasing this participation are undisputed. Indeed, FERC has made increasing demand participation a major focus of its SMD. Demand response can reduce the opportunities for market manipulation, and can allow reliability standards to be maintained without relying solely on new power plant development. Impediments to the development of retail markets will therefore not only harm consumers, but may limit the efficiency of wholesale markets, as well.

In a current Massachusetts proceeding regarding retail market development, ISO New England articulated this critical interdependence between wholesale and retail markets:

> A healthy wholesale energy market is linked to a strong and competitive retail energy market. Without retail customers responding to price signals, the wholesale market may not function properly...This linkage makes the pricing of retail service important to the wholesale market.[2]

This sentiment was echoed in FERC Chairman Pat Wood's recent testimony before Congress:

> One of the more crucial aspects of a successful wholesale power market is enabling customer demand response... [D]emand response to price is critically needed in wholesale markets, but it will only occur if retail customers see a price...and change their load accordingly.[3]

An active retail electric market also encourages marketers to adopt energy contracting strategies to reduce the price risk associated with serving load. These contract portfolios - which must be constantly adjusted in light of evolving conditions - will increase liquidity in forward energy markets. This will help improve long-term price signals, complement forward contracting efforts by generators, and reduce reliance on spot markets making them less prone to manipulation.

3 SMD provisions affecting retail development

Two aspects of FERC's SMD notice are of particular concern to Centrica, as we believe they will have a direct bearing on the ability of marketers to enter retail electric markets: (i) the Resource Adequacy Requirement and (ii) the initial allocation of Congestion Revenue Rights. Implementation of these concepts will require careful consideration to ensure they do not impede the development of the retail electric markets in Illinois.

3.1 Resource Adequacy Requirements

Marketers are Load-Serving Entities (LSEs) under the proposed SMD. Like all LSEs, a marketer would be a wholesale market participant, and would be subject to certain obligations. One such obligation under SMD would be the Resource Adequacy Requirement ("RAR"). Envisioned as a replacement to Installed Capacity ("ICAP"), RAR would require LSEs to arrange for sufficient generation or load-shedding resources to cover its share of anticipated regional power needs, plus a reserve margin of at least 12%.

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2 Initial comments of ISO New England Inc. in Massachusetts Department of Telecommunication and Energy docket D.T.E. 02-40, at 5-6. Comments available at http://www.state.ma.us/dpu/catalog/6820.htm

3 Testimony of Pat Wood, III before the Committee on Energy and Natural Resources. United States Senate. September 17, 2002.

FERC anticipates this allocation will be based either on historic or anticipated load served by each LSE. The peak load of a given LSE will vary not just with demand growth, but with changes in the number of customers a retailer serves. In a competitive retail market, where customers can switch marketers in response to better products or prices, expectations of peak load could vary widely and often. Neither of the proposed options for allocating RAR obligations adequately addresses this allocative uncertainty.[4]

To be truly effective in promoting the timely development of new capacity or load-shedding resources, RAR must look far enough into the future to trigger this development in advance of when it will be needed. FERC proposes to allow each planning region to determine the appropriate planning horizon, though it states that the planning horizon should be no shorter than the time for developing new resources. As the planning horizon for RAR is extended, however, the burden on LSEs of securing resources over this horizon increases. The uncertainty of future market share increases dramatically over time, and translating these uncertain projections into binding financial obligations poses a significant business risk to LSEs.

We suggest that the Commission urge FERC to reconsider its approach to allocating RAR responsibility. One alternative approach that would address FERC's policy objectives and warrants consideration is the use of a single agent - perhaps the Independent Transmission Provider already tasked with operating the energy markets - to coordinate the competitive procurement of future resources. A single-procurer model would remove the challenges associated with predicting the allocation of demand responsibility, and focus instead on meeting total market demand regardless of who serves it. Future resources would be competitively procured by the designated entity while the costs incurred would be recovered over the resource delivery period from LSEs in proportion to actual load served. Market participants could essentially self-procure resources, either on a net basis against their actual requirements, or by selling resource commitments to the system as a separate transaction. This approach would preserve competition in development of generation and demand resources while avoiding the complexity associated with *a priori* estimates of future load shares of specific LSEs.

3.2 Allocation of Congestion Revenue Rights

Under the locational marginal pricing ("LMP") that forms the basis of real-time prices under SMD, it is not only the *quantity* of electricity that is important, but also its *location*. In other words, it is not sufficient for a marketer to arrange electricity to be generated somewhere on the grid, this electricity must be delivered to the location where the customers actually consume it. Since electricity is rarely consumed where it is generated, this delivery must itself be arranged. This is achieved either through the possession of Congestion Revenue Rights ("CRRs") between various points in the grid, or by paying the congestion price in the real-time market. For all

4 One option is to base obligation on share of historic peak load. New marketers would have no such history, while marketers that are losing market share would pay disproportionately for resources. The other option is to base RAR responsibility on expected peak load, though FERC readily admits this raises the potential for misstating projections to reduce financial liability.

marketers, the ability to obtain CRRs will therefore be critical, since without them they will be fully exposed to real-time congestion prices.

FERC's SMD NOPR would leave design of the initial allocation of CRRs to the Independent Transmission Providers, to be specified in their compliance filings. One anticipated proposal is the allocation of CRRs to LSEs based on historic load volumes. Centrica is concerned that such an allocation would deter retail market development. The brief history of similar transmission rights in New York, for example, does not indicate that these rights are frequently traded; they tend to stay where they were initially allocated. Particularly troubling is the notion of allocating CRRs to incumbent LSEs, whose retention of these rights would pose an effective barrier to the entry of competing marketers.

Centrica urges the Commission to recommend that FERC reject an initial allocation of CRRs to incumbent LSEs, as these firms could hold CRRs to deter competitive retail entry rather than simply to hedge transmission price risk. Any initial allocation design must include specific provisions to prevent the use of CRRs as a barrier to entry.

4 Conclusion

Centrica supports FERC's efforts to improve the functioning of wholesale markets throughout the United States. Standardization of critical design features including real-time energy and congestion pricing, governance of market institutions, standards of conduct, and provisions for mitigating market abuse should all be pursued. The specific proposals to implement each objective reflect industry experience, and have benefited from an extensive consultation process. Centrica supports the FERC in this landmark effort.

As discussed above, the allocation of Resource Adequacy Requirement responsibility and the allocation of Congestion Revenue Rights pose significant challenges for marketers. First, determining the appropriate forward-looking allocation of RAR responsibility will be undermined by the significant uncertainty surrounding future market shares of individual marketers. This uncertainty raises the cost to LSEs of serving customers, while threatening the effectiveness of RAR in securing sufficient energy resources to maintain reliability. Second, the potential for allocating CRRs to incumbent LSEs could impede the entry of new competitors and give incumbent utilities an initial advantage over new entrants. Given the lack of significant trading activity in existing transmission rights, such an allocation raises a significant barrier to retail entry and should be rejected by FERC.

We appreciate this opportunity to share our views with the Illinois Commerce Commission. We support the Commission in its ongoing efforts to develop a competitive retail marketplace in Illinois in order to ensure that customers receive the best possible value in electric service.

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